

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B1-PLR-124844-02
Date:
June 28 2002

Legend

X =

Y1 =

D1 =

Property 1 =

Property 2 =

Property 3 =

Dear

This letter responds to a letter that you submitted, on behalf of X, dated April 19, 2002, requesting rulings under sections 1362(d)(3) and 1375(a) of the Internal Revenue Code.

According to the information submitted, X was incorporated in Y1 and elected under section 1362(a) to be an S corporation on D1. X has accumulated earnings and profits.

X is in the business of providing minorities with opportunities to acquire and develop properties in the communications industry. To diversity its investments, X wants to invest in entities that engage in the exploration and production of oil and gas. X intends to invest in Property 1, Property 2, and Property 3, which are publicly traded limited partnerships (PTPs) engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products.

X represents that the PTPs in which it seeks to invest meet the qualifying income exception, under section 7704(c), to the publicly traded partnership requirements under section 7704(a). X also represents that the normal flowthrough provisions of subchapter K apply to the PTPs' partners, because the PTPs are not electing to be excluded from any part of subchapter K under section 761(a), or to be treated as electing large partnerships under section 771.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for the taxable year.

Section 1362(d)(3)(A)(i) provides that an election under section 1362(a) terminates whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

Except as otherwise provided in section 1362(d)(3)(C), section 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Section 1375(a) provides that a tax is imposed on the income of an S corporation for any tax year in which the corporation has accumulated earnings and profits at the close of that year and gross receipts more than 25 percent of which are passive investment income.

Section 702(a)(7) of the Code provides that, in determining income tax liability, each partner shall take into account separately his distributive share of the partnership's items of income, gain, loss, deduction, and credit to the extent provided by regulations.

Section 1.702-1(a)(8)(ii) provides that each partner must take into account separately his distributive share of any partnership item that would result in an income

tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under section 702(a)(1) through (7) shall be determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Except as provided in section 7704(c), section 7704(a) of the Code provides that a PTP shall be treated as a corporation for federal income tax purposes.

Section 7704(b) provides that the term PTP means any partnership if interests in that partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that section 7704(a) shall not apply to a PTP for any tax year if the partnership meets the gross income requirements of section 7704(c)(2) for that year and each preceding tax year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Section 7704(c)(2) provides that a partnership meets the gross income requirement for any tax year if at least 90 percent of the partnership's gross income for that year consists of qualifying income.

Section 7704(d)(1)(E) provides that income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber) is qualifying income. For the purposes of this section, mineral or natural resource means any product of a character with respect to which a deduction for depletion is allowable under section 611, but is not a product described in section 613 (b)(7)(A) or (B).

Rev. Rul. 71-455, 1971-2 C.B. 318, deals with an S corporation that operates a business in a joint venture with another corporation. In the tax year at issue, the total business expenses exceeded gross receipts. The revenue ruling holds that, in applying the passive investment income limitations, the S corporation should include its distributive share of the joint venture's gross receipts and not its share of the venture's loss. In accordance with section 702(b), the character of these gross receipts were not converted into passive investment income upon their allocation to the S corporation.

X's distributive shares of gross receipts from the PTPs, if separately taken into account, might affect its federal income tax liability. Under section 1362(d)(3), the status of X as an S corporation could depend upon the character of its distributive shares of gross receipts from the PTPs. Thus, pursuant to section 1.702-1(a)(8)(ii), X

must take into account separately its distributive shares of the gross receipts from the PTPs. The character of these partnership receipts for X will be the same as the character of the partnership receipts for the PTPs, in accordance with section 702(b).

Based solely on the facts and representations submitted, we conclude that:

1) X's distributive share of the gross receipts of the PTPs, in which it intends to invest, will be included in its gross receipts for purposes of section 1362(d)(3) and section 1375(a); and 2) X's distributive shares of the PTP's gross receipts attributable to the purchasing, gathering, transporting, trading, storing, and reselling crude oil and refined petroleum products will not constitute passive investment income as defined by section 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X is eligible to be an S corporation. Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,
/s/ David R. Haglund

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy for section 6110 purposes
Copy of this letter
cc: